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C O N F I D E N T I A L BUENOS AIRES 000421

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E.O. 12958: DECL: 04/04/2018
TAGS: ECON EAGR EINV ETRD AR
SUBJECT: (U) ARGENTINA: STRIKE'S ECONOMIC COSTS VS. ITS $$
RATIONALE

REF: A. BUENOS AIRES 415

¶B. BUENOS AIRES 368 AND PREVIOUS
¶C. 07 BUENOS AIRES 2110

Classified By: Ambassador E.A. Wayne. Reasons 1.5 (B,D)

Introduction and Summary

¶1. (C) Now that the Argentine farm sector,s strike measures have been lifted, at least for 30 days (Ref A), it is worth examining just why the GoA chose this particular moment to boost export taxes, and what economic costs the three-week strike have imposed on the Argentine economy. In our view, the tax increase was driven by: 1) an opportunistic GoA desire to capture pre-harvest rents from the spectacular early 2008 run-up in international soy commodity prices; 2) by the desire to maintain a 3-4%/GDP primary fiscal surplus in the face of skyrocketing domestic subsidy expenses; and 3) by the need to support the central bank's efforts to maintain an undervalued peso. Many here see an underlying political motivation as well: unlike other taxes, export tariff revenues are not automatically shared with provinces, and so increased federal revenues further tie the interests of deficit-prone provincial governors to those of a patronage-wielding president.

¶2. (SBU) It appears the three-week agricultural sector strike has cost the GoA more than the roughly $1.2 billion it was projected to earn from the increase in export tariffs. With nation-wide industrial and commercial production severely constrained by road blockages, analysts are putting the strike's cost to date on lost agricultural, industrial and commercial production at roughly US$ 1.5 billion, or 0.5% of GDP. Additional costs of the strike include contractual penalties Argentine exporters will face as well as strike-related sector-specific temporary layoffs, inventory, and payment expenses.

¶3. (C) The Argentine agriculture sector, with a net tax burden of over 70%, feels it is being squeezed to fuel a spendthrift government's public-spending binge and growing subsidy payments, both of which they feel largely benefit urban consumers, not rural communities. Over the past year such GoA spending has overheated an already robust economic recovery and so fueled inflation that is eating into urban incomes and exporters' competitiveness. The higher agricultural sector tax burden discourages the allocation of economic resources to investments needed to support agricultural production, arguably Argentina's most efficient and competitive sector, and raises GoA fiscal account exposure to the international commodities cycle. Many

non-government economists and analysts here are arguing that Argentina would do well to reduce its reliance on inefficient export tariffs in favor of progressive income taxes and social safety net food subsidies. They also argue that Argentina would do well to take a lesson from neighboring Chile and save at least a portion of current commodity windfalls for inevitably leaner times ahead. End Introduction and Summary.

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GoA's March 11 Boost in Export Taxes: Why Now?
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¶4. (SBU) Embassy GoA contacts in the Ministry of Economy and independent economists here originally estimated that the GoA's March 11 introduction of a significant increase in soy export tariffs (plus a scaled linkage of all agricultural export tariffs to global commodity prices for oilseeds and grains) would raise an additional US$ 1.2 billion (roughly 0.4% of GDP) at prevailing global commodity price levels. Based on rough GoA projections, such additional export tax revenues would increase the contribution of export taxes to overall GoA revenue intake from 10% in 2007 to roughly 14% in
¶2008.

¶5. (SBU) In their after-the-fact justification of this increase in export tariffs on soy products, President Cristina Fernandez de Kirchner (CFK) and her Economy Minister Martin Lousteau spoke of the GoA's popular mandate to ensure that domestic food supplies remain affordable; to allow the GoA to re-distribute the agricultural sector's windfall profits via targeted subsidies; to prevent a risky monoculture "soyization" of the Argentine agricultural sector at the expense of other cereal grains; and to maintain a healthy primary fiscal surplus and reserve accumulation that, in turn, insulates Argentina from external shocks and

pressures (Ref B). The GoA has also justified its implementation of a sliding scale of agricultural commodity tariffs linked to global commodity prices as a means to provide domestic grain and cereal producers more certainty in projecting their future revenue streams as they contemplate new capital expenditures. But the question remains as to why the GoA chose this particular moment to introduce another substantial increase in export taxes.

¶6. (SBU) The imposition of economically inefficient export tariffs is not new to Argentina. They were first introduced in the 1970s, and variously used to control domestic prices and to impose effective differential exchange rates for targeted sectors of the economy. After falling out of favor in the 1990s during President Menem's efforts to reform the Argentine economy, they were "temporarily" re-introduced following the 2001/2 financial crisis by then-President Duhalde to strengthen the primary fiscal surplus and expand the volume of revenues directly under the control of the federal executive. (Export tariffs are not included in the list of federally collected taxes shared with Argentina's 23 provinces under a "co-participation" revenue sharing formula.) Former President Nestor Kirchner subsequently increased export taxes on three occasions in 2004, 2006, and in October 2007, shortly before he left office. According to local analysts, while the 2004 and 2006 export taxes increases were geared to controlling domestic food prices and providing resources to subsidize food and transportation prices, the October 2007 increase was imposed to ameliorate the fiscal impact of a pre-November 2007 presidential election public expenditure binge (Ref C) that imperiled the GoA's oft-repeated goal of maintaining a primary fiscal surplus in the 3-4% of GDP range.

¶7. (SBU) There does not appear to be one single overriding GoA justification for this last March 11 export tariff increase. According to a broad range of Embassy GoA contacts and local analysts, it was developed by the GoA as (1) an opportunistic move to capture pre-harvest rents from the spectacular early 2008 run-up in international soy commodity prices; (2) to provide additional revenues needed to maintain

a primary fiscal surplus in the 3-4% of GDP range in the face of skyrocketing domestic subsidy expenses (in 2007, GoA subsidy payments, primarily to the energy, transportation and agricultural sectors, jumped 83% y-o-y to ARP 16.1 billion/US$ 5.1 billion from ARP 8.8 billion in 2006; the rate of spending has slowed thus far in 2008); and (3) to provide the federal treasury additional resources to support central bank efforts to maintain an undervalued peso. (The Central Bank has been struggling to sterilize its purchases of Argentina's large FX inflows and so limit inflationary expansion of the money supply without raising interest rates. GoA Treasury FX purchases do not expand the money supply and so require sterilization.)

¶8. (SBU) Additionally, many here ascribe an underlying political motivation to the GoA's March 11 export tariff increase that is rooted in the historical competition for resources between the relatively sparsely populated provinces and the greater Buenos Aires metropolis. Because export tariff revenues are not automatically shared with provinces, this latest increase, they say, was a move to gain control over a larger share of federal revenues and thus wield greater discretionary control over provincial governors, whose deficits are partially funded by the federal government. (Many of Argentina's 23 provinces are facing growing budget constraints, with inflation-linked expenditures on salaries for teachers and their bloated civil servant corps up significantly in recent years, while co-participated tax revenues have not kept pace.)

¶9. (SBU) While larger provinces, including Buenos Aires, Mendoza, and Neuquen (as well as the Buenos Aires city federal district), have been able to issue debt locally and internationally, they have all requested additional federal funding to make up shortfalls. For example, Buenos Aires. province expects to raise roughly half of its 2008 financing needs of US$ 1.5 billion from the markets, but must rely on the GoA for the remainder. Former Central Bank Governor (and recent shadow Economy Minister of Presidential candidate Elisa Carrio) Alfonso Prat Guy estimates that, for each 5% increase in federal export tariffs that reduce producers gross receipts, the provinces collectively lose 1% of co-participated income tax revenue. He estimated the net tax loss to provinces due to the GoA's imposition of all export tariffs at roughly US$ 2.5 billion.

Strike Impact on Production, GDP, Revenues

¶10. (SBU) It appears that the three-week agricultural sector strike has cost the GoA more than the roughly $1.2 billion the GoA was projected to earn from the March 11 increase in export tariffs. With nation-wide industrial and commercial production severely constrained by road blockages, a report published April 1 in financial daily Cronista put the strike's cost to date on agricultural, industrial, and commercial production at over ARP 5 billion (US $1.6 billion), roughly 0.5% of GDP. An earlier March 29 report in daily La Nacion put the strike's cost at roughly about ARP 300 million (US$ 95 million) per working day, only taking into account industry and transport. This would put the total cost of the protests at 0.4% of GDP.

¶11. (C) On April 1, the GoA reported March tax revenues of ARP 17.7 billion (US$ 5.6 billion) up 27% y-o-y in nominal terms, (versus a 45% average increase in each of the prior three months), the lowest nominal growth rate since inflation surged in early 2007. Weak tax collection can belargely explained by the mid-March halt in exports of cereals and grains, but Easter holidays (early this year in March) likely also played a role. Taxes on commodity exports) agricultural goods, oil, and gas) account for about 12% of total tax collection and are estimated to reach 3.3% of GDP in 2008, if prices of commodities hold up at the early 2008 levels). The GoA has yet to release a breakdown of March tax collections but, because the agrarian strike and associated

road blocks disrupted economic activity throughout Argentina, it is likely that collection of other taxes (VAT taxes, income taxes, etc.) were also weak in March.

¶12. (SBU) Additional costs of the strike include likely contractual penalties that Argentine exporters will have to face due to their failures to fulfill contracts, despite their declarations of "force majeure." The Executive Director of the Chamber of the Vegetable Oil Industry in Argentina (CIARA), Alberto Rodriguez, said March 27 that the strike prevented ships from being loaded with some 2.2 million tons of grains, oils, and flours, with each of 75 waiting ships facing daily average demurrage charges of US$ 60-70,000. Anecdotal reporting in the media also discusses strike-related sector-specific temporary layoffs as well as inventory and payment problems. The automobile sector is short of auto parts from both Brazilian and domestic suppliers. Flour mills shut down by the strike negotiated lay-off terms with their unions. The poultry chamber reported that domestic producers killed 1.3 million chickens due to storage constraints problems. Dairy cooperatives with insufficient storage capacity dumped milk stocks and defaulted on payments to suppliers.

Comment

¶13. (C) Under the new export tariff scheme, soy producers pay a hefty 44% on exports at current world prices of roughly US$465/ton. Added to income tax and provincial levies, this top rate results in a total tax burden on farmers of over 70%, according to the Argentine Agrarian Federation, but the effective weight varies given other costs carried by various producers (e.g., higher transport costs in more distant provinces). The GoA argues that higher tariffs are needed to ensure a more equitable sharing of the windfall from historically high commodity prices. But the Argentine agriculture sector feels the GoA is failing to take into account rapidly rising production costs, and that its members are being squeezed to fuel a spendthrift government's growing subsidy payments and a public-spending binge, both of which they feel largely benefit urban consumers. The constant complaint is the lack of public sector involvement in agricultural provinces' schools, hospitals and roads, etc. What is certain is that such GoA spending has overheated an already robust economic recovery, fueling inflation that is eroding urban incomes and agricultural exporters' own competitiveness.

¶14. (C) The GoA's interest in tapping the global commodity boom to fund federal coffers mirrors efforts by other primary commodity exporting nation governments worldwide. While the GoA's goal of boosting its primary fiscal surplus is laudable, this higher sector-specific tax burden discourages the allocation of economic resources to agriculture, arguably Argentina's most efficient and competitive sector, in favor of other less competitive sectors of the economy. Moreover, the boost in agricultural export taxes raises GoA fiscal account exposure to the international commodities cycle,

increasing the risk of an abrupt fiscal adjustment and a deterioration in debt dynamics if and when international commodity prices decline. Local economists have long questioned the efficiency of export tariffs, arguing that better implementation of progressive income taxes combined with food subsidies to the poor would resolve many of the gross economic distortions to which export tariffs have contributed. They also argue that Argentina would do well to learn from the example of neighboring Chile and revive the GoA's moribund anti-cyclical fund (established by former Economy Minister Roberto Lavagna in 2004) to save at least a portion of current commodity windfalls for inevitably leaner times ahead.
WAYNE